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MEMORANDUM

TO: Docket Control

FROM: Ernest G. Johnson
Director
Utilities Division

DATE: March 22, 2005

RE: STAFF REPORT FOR LEVEL 3 COMMUNICATIONS, LLC, APPLICATION FOR AUTHORIZATION TO PLEDGE ASSETS AND GUARANTEE DEBT (DOCKET NO. T-03654A-04-0910)

Attached is the Staff Report for Level 3 Communications, LLC application for authorization to pledge assets. Staff recommends approval.

EGJ:JHJ:red

Originator: J. H. JOHNSON

Attachment: Original and sixteen copies

Service List for: Level 3 Communications, LLC
Docket No. T-03654A-04-0910

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STAFF REPORT
UTILITIES DIVISION
ARIZONA CORPORATION COMMISSION

LEVEL 3 COMMUNICATIONS, LLC

DOCKET NO. T-03654A-04-0910

**APPLICATION FOR AUTHORITY
TO PLEDGE ASSETS AND
GUARANTEE DEBT**

MARCH 2005

STAFF ACKNOWLEDGMENT

The Staff Report for Level 3 Communications, LLC, Docket No. T-03654A-04-0910 was the responsibility of the Staff members listed below: J. H. Johnson was responsible for the review and financial analysis of the Company's application.

J. H. JOHNSON
PUBLIC UTILITIES ANALYST III

EXECUTIVE SUMMARY
LEVEL 3 COMMUNICATIONS, LLC
DOCKET NO. T-03654A-04-0910

Level 3 Communications, LLC ("Level 3" or "Company") filed an application with the Arizona Corporation Commission ("Commission") on December 17, 2004, requesting authorization to pledge assets and execute a guarantee in support of debt financing by its corporate parent, Level 3 Financing, Inc. ("L3F"). Level 3 is a wholly owned subsidiary of L3F, which in turn is a wholly owned subsidiary of Level 3 Communications, Inc.

Level 3 is authorized to provide resold and/or facilities-based telecommunications services nationwide pursuant to certification, registration, or tariff requirements or on a deregulated basis. Level 3 is also authorized by the Federal Communications Commission to provide international and domestic interstate services as a non-dominant carrier.

In Arizona, Level 3 serves 333 customers composed of 4 governmental entities and 329 business/wholesale customers utilizing Arizona based assets having a book value of $122,438,153 as of December 31, 2003.

On December 2, 2004, L3F completed purchase of $1.105 billion principal of outstanding debt due in 2008. The purchase reduced amounts due in 2008 to approximately $1.3 billion, a 46 percent reduction in required debt service. Funding for the purchase was provided by new debt issues of $1,075,000,000 that extended the maturities of the debt amount purchased and reissued to 2011.

The refinancing resulting in a negative 1.11 times interest earned ratio ("TIER") and a positive 0.32 debt service coverage ratio ("DSC"). Both ratios are inadequate for consideration of any kind of financing, however, the lender in this transaction does not require maintenance of any ratios. The application states that interest savings from the refinancing are expected to be $28 million in the first year. The capital structure is unchanged due to the reissued debt.

The financial performance and capital structure as described in the preceding paragraphs would normally preclude authorization of the requested pledge of assets. Since Level 3 has only governmental and business customers and there are many other sources for services provided by Level 3, Staff concludes that Level 3 customers have other means of acquiring these services and would not be materially harmed by Level 3's parents' default on the loan facilities, or demise.

Staff concludes that authorization is warranted because the refinancing extends maturities on debt obligations providing enhanced ability to repay existing debt.

Staff recommends the approval of Level 3's request for authorization to pledge its assets and guarantee debt in support of loans in the amount of $1,075,000,000 obtained by L3F on the terms and conditions described in the application.

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SCHEDULE

Introduction

Level 3 Communications, LLC ("Level 3" or "Company") filed an application with the Arizona Corporation Commission ("Commission") on December 17, 2004, requesting authorization to pledge assets and guarantee debt in support of debt financing by its corporate parent, Level 3 Financing, Inc. ("L3F"). Level 3 is a wholly owned subsidiary of L3F, which in turn is a wholly owned subsidiary of Level 3 Communications, Inc. All three entities are Delaware based with headquarters in Broomfield, Colorado, a suburb of Denver.

Notice

No Notice is provided as applicant has only Governmental and business customers.

Background

Level 3 is authorized to provide resold and/or facilities-based telecommunications services nationwide pursuant to certification, registration, or tariff requirements or on a deregulated basis. Level 3 is also authorized by the Federal Communications Commission to provide international and domestic interstate services as a non-dominant carrier.

In Arizona, Level 3 serves 333 customers composed of 4 governmental entities and 329 business/wholesale customers utilizing Arizona based assets having a book value of $122,438,153 as of December 31, 2003. Level 3 has 14 employees in Arizona. The financing will not change employment numbers in Arizona.

Purpose of Financing

On December 2, 2004, L3F completed purchase of $1.105 billion principal of outstanding debt due in 2008. The purchase reduced amounts due in 2008, to approximately $1.3 billion, a 46 percent reduction in required debt service. Funding for the purchase was provided by new debt issues of $1,075,000,000 that pushed the maturities of the amount purchased and reissued to 2011. The transaction further reduced annual cash interest expense by $28 million enhancing L3F's ability to repay existing debt. The application states that none of the obligations described will apply to Level 3 until required regulatory approvals are obtained.

Description of Proposed Financing

L3F offered for sale $345 million of 5.25 percent convertible notes due in 2011 as part of the credit package. Most of the proceeds of the note sales along with $730 million of funding from a senior secured term loan were used to complete the refinance. A portion of the proceeds were used to enter into bond hedge and warrant transactions related to its common stock. All transactions were with private qualified institutional buyers and were not registered with the Securities and Exchange Commission.

The $345 million convertible debt can be exchanged at any time, subject to certain adjustments, for 251.004 shares of common stock per $1,000 debt face value as long as the conversion takes place before December 15, 2011. The conversion rate equates to $3.984 per share.

The Credit Agreement does not require the maintenance of certain financial ratios but specifies events of default only.

Financial Analysis

Staff's financial analysis is based on annualized September 30, 2004, financial statements for Level 3 Communications, Inc., the parent company. Level 3 stated in the response to Data Request JHJ - 1.4 that its financial numbers are consolidated with other subsidiaries and the parent, Level 3 Communications, Inc.

Consolidated financial statements for September 30, 2004 (the latest quarter available) are taken from Form 8-K provided in response to Data Request JHJ - 1.4

The consolidated entities had operating losses of $381 million for the nine (9) month period ended September 30, 2004. This represents an improvement over the $590 million loss in the similar period the previous year.

Schedule JHJ-1, attached, shows modest changes to the times interest earned ratio ("TIER") and debt service coverage ratio ("DSC") based on the reissuance of debt due in 2008 to a new maturity of 2011. The refinancing changes the TIER from -1.05 in Column A to -1.11 in Column B while DSC increases from 0.30 in Column A to 0.32 in Column B. Both ratios are inadequate for consideration of any kind of financing, however, the lender in this transaction does not require maintenance of any ratios. Schedule JHJ-1, Column B, reflects the Company's expected $28 million interest expense savings in the first year. All entries in Column A and Column B are based on the nine-month results and then annualized on the assumption that the fourth quarter financial results would be comparable to the other three quarters.

The capital structure is unchanged on Schedule JHJ-1 as current (short-term) maturities are believed to be unaltered and the amount of debt outstanding is approximately the same. Level 3 Communications, Inc. and its subsidiaries remain extremely leveraged with a negative worth capital structure. The capital structure would improve if the new $345 million of convertible debt was converted to common stock and losses are less than that amount.

Financial performance and capital structure as described in the preceding paragraphs would normally preclude authorization of the requested pledge of assets. Since Level 3 has only governmental and business customers and there are many other sources for services provided by Level 3, Staff concludes that Level 3 customers would have other means of acquiring these services and would not be materially harmed by Level 3's parents' default on the loan facilities or demise. Further, as $345 million of the debt package is convertible to common stock, upon conversion, Level 3's consolidated capital structure could improve.

The DSC represents the number of times internally generated cash will cover required principal and interest payments on long-term debt. A DSC greater than 1.0 indicates that operating cash flow is sufficient to cover debt obligations.

TheTIER represents the number of times earnings will cover interest expense on long-term debt. A TIER greater than 1.0 means that operating income is greater than interest expense. A TIER less than 1.0 is not sustainable in the long term but does not necessarily mean that debt obligations cannot be met in the short term.

Compliance

There are no compliance issues with this company.

Staff Conclusions and Recommendations

Staff concludes that the pledge of assets and guarantee in support of an affiliates financing is within the corporate powers of Level 3, compatible with the public interest, and will not impair its ability to perform service.

Staff further concludes that authorization is warranted because the refinancing extends maturities on debt obligations resulting in enhanced ability to repay existing debt.

Staff recommends the approval of Level 3's request for authorization to pledge its assets in support of loans in the amount of $1,075,000,000 obtained by L3F on the terms and conditions described in the application.

Staff further recommends approval of granting of liens in favor of the lender as required to secure the borrowings authorized.

Staff further recommends authorizing Level 3 to engage in any transaction and to execute any documents necessary to effectuate the authorizations granted.

Level 3 Communications, Inc. (Consolidated)
Docket No. T-03654A-04-0910
Application For Asset Pledge and Guarantee

Schedule JHJ-1

FINANCIAL ANALYSIS

Selected Financial Data [1]
Including Immediate Effects of the Proposed Debt
(In millions, annualized)

Line		[A] 9/30/2004 Pre-refinancing		[B] Pro Forma Post-refinancing	
1	Operating Income	$ (508)		$ (508)	
2	Depreciation & Amort.	701		701	
3	Income Tax Expense	(3)		(3)	
5	Interest Expense	487		459	
6	Repayment of Principal	144		144	
9	**TIER**				
10	[1+3] ÷ [5]	-1.05		-1.11	
11	**DSC**				
12	[1+2+3] ÷ [5+6]	0.30		0.32	
18	Short-term Debt	$144	2.9%	$144	2.9%
20	Long-term Debt	$5,032	100.3%	$5,032	100.3%
22	Common Equity	($159)	-3.2%	($159)	-3.2%
24	Total Capital	$5,017	100.0%	$5,017	100.0%

26 [1] Amounts reflect annualization of 9 month results.